M E M O R A N D U M

To: File No. S7-33-10

From: Stephen L. Cohen
Associate Director, Division of Enforcement

Date: January 30, 2011

Re: Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934

On January 27, 2011, Jordan Thomas and Stephen Cohen of the Division of Enforcement and Thomas Karr and Richard Levine of the Office of General Counsel met with the following individuals: Tom Devine, Legal Director, Government Accountability Project, Reuben Guttman, Co-Founder of Voices for Corporate Responsibility and director at Grant & Eisenhofer, Michael Smallberg, Project on Government Oversight, Patrick Szymanski, General Counsel, Change to Win, Raymond Fay of Mehri & Skalet PLLC, and Jason Zuckerman, Principal, The Employment Law Group.

The participants discussed the Commission's proposed rules implementing the whistleblower provisions of Section 21F of the Securities Exchange Act of 1934. Specific topics of discussion included:

1. Industry proposal to require internal whistleblowing.
2. Coordinating inter-agency investigations of related actions.
3. Impact of barring awards to whistleblowers who disclose violations to other agencies.
4. Sharing information with whistlelowers and updating whistleblowers on the status of an investigation.
5. Excluding organizations from the definition of "whistleblower."
6. Proposed definitions of "original information" and "independent knowledge."
7. Requirement to prove that disclosure led to a successful enforcement action.
8. Proposed definition for the term "action."
9. Proving that information led to a successful enforcement action.
10. Proposed procedures to make a claim for an award.
11. Confidentiality of submissions.
12. Prohibiting use of confidentiality agreements to bar whistleblowing to the SEC.
13. Comments submitted by Voices for Corporate Responsibility and POGO (already posted).

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February 18, 2011

Elizabeth M. Murphy
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Supplemental comments on File S7-33-10, Proposed Rule for Whistleblower Provisions in Section 21F of the Securities Exchange Act

Dear Ms. Murphy:

These supplemental comments are submitted at the request of Securities and Exchange Commission (SEC) staff from a January 27, 2011 stakeholders meeting. The comments provide further research and support for points asserted at the meeting, when the Government Accountability Project (GAP) and other participants voiced a basic conclusion throughout the whistleblower community: It would turn the recent congressional reform into a counterproductive caricature if mandatory internal reporting were a prerequisite for rights or rewards under the Section 21F whistleblower program.

At the meeting GAP emphasized three primary themes: 1) Mandatory internal disclosures are unnecessary, if corporations have an effective safe whistleblower policy and channel, employees overwhelmingly will make that choice voluntarily. Corporations should voluntarily create those policies and channels, because whistleblowers are their most valuable resource against internal fraud. 2) Mandatory prior internal reporting prior to government disclosures could create insurmountable obstacles to civil and criminal prosecutions. 3) There cannot be any exception in the whistleblower program for those carrying out job duties connected with the disclosure.

1) <u>Mandatory prior internal reporting is unnecessary</u>.

As discussed, in addition to fear of retaliation there are tremendous social and cultural barriers to an employee "going outside the family" to blow the whistle. They include accumulated trust in the institution, corresponding loyalty, a history of successful internal problem solving, personal identity developed throughout a career, and effects on colleagues. A 2010 Ethics Resource Center report supplementing its 2009 National Business Ethics Survey, found that only 4% of whistleblowers make their disclosures outside the corporate system, and only 3% even to hotlines. 46% went to their supervisor.[i] In short, it takes extreme concern over institutional bad faith before an employee will blow the whistle to a third party, or even outside the normal chain of command.

It is in corporations' self-interest to recruit open communications from whistleblowers. The 2010 Ethics Resource Center report also found that while some 50% of employees witness misconduct on the job, roughly 40% do not act on their knowledge.[ii] Silence from those 40% undermines corporate efforts to prevent or recoup losses. A 2007 PricewaterhouseCoopers global crime survey of over 5,400 companies in 40 countries found that 43 percent had been victimized by one or more serious economic crimes, and that 80 percent of that group reported damage or significant damage to their institutions.[iii] The average loss from fraud per company was more than $3.2 million in 2007.[iv] Furthermore, PricewaterhouseCoopers reported that whistleblower hotlines as well as internal and external sources were the initial means of detection in 43 percent of the cases, more than the combined results from corporate security, internal audits, fraud risk management, rotation of personnel, and law enforcement.[v] Similarly, a 2008 report of the Association of Certified Fraud Examiners, reviewing 959 cases of fraud, credited exposure of 46.2% of that fraud to tipsters, compared to only 3.2% detected by law enforcement. 57.7% of the tips came from employees. The Association advised that employees "should be encouraged to report illegal or suspicious behavior, and they should be reassured that reports may be made confidentially and that the organization prohibits retaliation against whistleblowers."[vi] It pays to listen to the messenger.

Industry lobbyists demanding mandatory prior internal disclosures seek to impose an unprecedented prior restraint on communications with the government about illegality. None of the 47 corporate whistleblower statutes require mandatory company disclosures as a prerequisite for rights. This includes the Sarbanes Oxley and Dodd Frank provisions in section 1057 of the law, both which will overlap with many Section 21F disclosures.

The lesson from this research is clear. The demand for unprecedented mandatory prior disclosures is misplaced. Being a whistleblower's first option comes from trust, not prior restraint, and earning that trust is good business.

2) <u>Mandatory prior internal disclosures could create insurmountable obstacles to criminal and civil law enforcement actions</u>.

As discussed above, unless there is overwhelming evidence of institutional bad faith, i.e., intentional illegality and criminal liability, employees trust and voluntarily operate through normal company channels. When that trust has been breached, it would be foolhardy to provide advance knowledge of the employee's evidence to a potential civil or criminal defendant. Whether a bad faith institution is the potential defendant in an SEC enforcement action or a Justice Department prosecution, it can be a decisive advantage to know all the evidence that threatens liability. The opportunity for a customized cover up before the government learns of misconduct can sabotage the prospects for civil or criminal law enforcement.

This basic fact of life for law enforcement long has been recognized. In the 1980's the Department of Justice testified at congressional hearings about the counterproductive impact of a Nuclear Regulatory Commission (NRC) program that rechanneled whistleblowers' allegations and evidence back to the industry for response, instead of independently investigating the disclosures. Justice stated that this made effective criminal prosecutions impossible, because the defendants had advance warning of the evidence, advance opportunity to cover up intentional misconduct and advance opportunity to perfect defenses.[vii]

The success of America's most effective anti-corruption statute, the False Claims Act, would not have occurred if industry had succeeded in an analogous campaign for Congress to impose deference to internal corporate programs. Sparked by the Act's early success, in 1993 a coalition of 22 contractors, nicknamed the "fraud lobby," launched a campaign to gut the law. Since 1990, nearly all of the contractors had pled guilty or paid fines totaling hundreds of millions of dollars for fraud, 17 of them on multiple incidents. During their legislative efforts, the lobby's members faced 28 active, unsealed *qui tam* suits. As Senator Grassley summarized, "They hate the Act because it is very effective at exposing their fraud."[viii]

The showdown was over proposed industry legislation to ban citizen suits once a company announced related internal investigations through a voluntary disclosure program. In the end, there was so little credibility for the idea that lobbyists could not find as single sponsor for the legislation. Relevant for the current proposal is a 1996 GAO report that concluded government and corporate disclosure channels complement each other, that *qui tam* suits help to keep voluntary disclosure programs more honest.[ix]

On balance, the track record demonstrates that voluntary disclosure programs are not an effective substitute for independent law enforcement, and too often serve as a shield for liability. Summarized below are lessons learned about corporate hotlines and voluntary disclosure programs from a review of whistleblower cases since 1979. Programs have been:

* incomplete in scope, because institutions set the boundaries for investigations, which at times have been limited to exploring the "tip" of the misconduct and ignoring the rest of the "iceberg";

* incomplete in their findings of fact, because companies elect not to disclose the most significant misconduct;

* inadequate even for government oversight, because firms can and do rely on claims of "commercial or proprietary" information and the attorney-client privilege to withhold key records in corporate investigative files from government auditors;

* a rationale for delaying formal proceedings while a company's self-investigation proceeds – taking 2.8 years on average and over ten years in some of the cases surveyed by a 1996 Government Accountability Office study;[x]

* a form of advance discovery for future litigation, which at worst creates opportunities to intimidate or influence witness testimony and at best provides early knowledge of – and a corresponding opportunity to rebut – significant, threatening testimony; and

* openly advocated in industry speeches as a way to avoid independent government scrutiny and harsher government enforcement action, despite official disclaimers that the programs' purpose is good corporate citizenship.

These type vulnerabilities are most likely, when the institution has lost a whistleblower's trust and mandatory prior disclosure to the company would give the defendant the hard start to defeat law enforcement. In short, the only firms who will not get first crack at the evidence are the last who should benefit from that preview.

3) <u>There cannot be any exception in the whistleblower program for those carrying out job duties connected with the disclosure</u>.

The proposal to exempt those with associated job duties is a direct attack on the law's objectives. The purpose of the Section 21F program is to obtain the highest volume, highest quality evidence when there are intentional violations of SEC rules. No witnesses are more knowledgeable or credible to provide that evidence than employees responsible to carry out the corporation's internal checks and balances for compliance. To illustrate, they can navigate the difference between good faith errors, and confirmed violations followed by bad faith or nonexistent corrective action.

Whistleblower protection laws long have covered those carrying out job duties, because they are the most direct witnesses to evidence of violations.[xi] None of the 47 whistleblower statutes excludes protection for job duties, and section 1057 of the Dodd Frank law explicitly includes that context as protected activity.

On balance, the industry proposals to weaken Section 21F are not new. They reflect challenges to whistleblower laws for decades. None of them has been accepted in any of the corporate whistleblower statutes. The SEC should not set public policy precedents rejected by Congress so many times for so long.

Respectfully submitted,

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[i] Ethics Resource Center, *Reporting: Who's Telling You What You Need to Know, Who Isn't, and What You Can Do About It*, at 15 (2010)
[ii] *Id.* at 1.
[iii] PricewaterhouseCoopers and Martin Luther University Economy and Crime Research Center, *Economic Crime, People, Culture and Controls: The 4th Biennial Global Economic Crime Survey* (2007), http://www.pwc.com/extweb/home.nsf/docid/29CAE5B1F1D40EE38525736A007123FD.
[iv] *Id.* at 8.
[v] *Id.* at 10.
[vi] *2008 Report to the Nation on Occupational Fraud and Abuse* (Society of Certified Fraud Examiners 2008) , at 4, 30.
[vii] *See, e.g., Sacramento Bee,* "Nuclear Inspections Criticized, Testimony Alleges" (April 10, 1987); *Fresno Bee,* "NRC Probes Hurt by its Staff, Panel Told" (April 10, 1987).
[viii] K.R. Sawyer, "The Test Called Whistleblowing," paper delivered to the National Conference of Whistleblowers Australia (September 11, 2005).
[ix] *Id.*
[x] Voices of Scientists at FDA: Protecting Public Health Depends on Independent Science, Union of Concerned Scientists (2006) at 2, http://www.ucsusa.org/assets/documents/scientific_integrity/FDA-Survey-Brochure.pdf.
[xi] *Mackowiak v. University Nuclear Systems*, 735 F. 2d 1159 (Ninth Cir. 1984).